

International  
Support  
Policies  
to  
South-East  
European  
Countries

Lessons  
(Not)  
Learned  
In

## CHAPTER IV

DRAGOLJUB STOJANOV

### **BOSNIA-HERZEGOVINA SINCE 1995: TRANSITION AND RECONSTRUCTION OF THE ECONOMY**

#### **1. Introductory Remarks**

Bosnia-Herzegovina is in the process of transformation from a non-market, previously self-managed economy to a modern market economy. The process was started at the beginning of 1996, immediately after the Dayton Peace Accord was signed.

The transition package being implemented is based on the “rules of the game” of the **Washington Consensus**. At the international level, the IMF, the World Bank and USAID have so far led the transition.

When the transition began, there was the promise and expectation of a “blooming landscape”. Five years later, it seems more like a mirage.

Economic development has hardly started. Data about the economic and social situation in B-H can be found in the following chapters.

It is becoming obvious that an **alternative solution** is needed for economic development in the country. This conclusion is construed on the basis of more detailed analyses in other parts of the Study.

We share the opinion that increase in productivity and competitiveness are the key to the transition from the formerly socialist economies in Eastern Europe. In the medium term there is no other way. Macroeconomic policy can only contribute in the short run. This underscores the importance of **supply side industrial policies for productivity, competitiveness and convergence**,<sup>1</sup> the element which has been missing from the package of the “Washington Consensus”.

#### **2. The Economy Before 1991**

Between the Second World War and 1991, when Bosnia-Herzegovina was one of six republics of the former Yugoslavia, it achieved significant economic transformation. Economic growth averaged 5 per cent a year. In 1991 per capita income was \$US 2,400, excluding the service sector, as was the practice in former socialist economies.

Twelve big companies produced 35 per cent of the gross domestic product (GDP), and four of them generated more than 40 per cent of total exports. Companies were organized as self-managed companies of associated labor, in accordance with the principle of a self-managed market economy, which was half way between a centrally planned and a modern market economy.

In 1990-1991, Bosnia's main foreign trade partners were the former USSR, Germany and Italy. It had a surplus in its trade with the EEC countries in 1991. Main

---

<sup>1</sup> Pitelis, C. *Supply-side Strategy for Productivity, Competitiveness and Convergence Between CEECs and EU*, PHARE-ACE project.

exporting sectors were chemicals, ferrous metallurgy, metal processing, leather shoes, electrical appliances, finished wood, timber and panels, and finished textiles.

### 3. The Economy Since the War

#### 3.1. On the Road of Economic Deconstruction

Before the war Bosnia had almost 4.4 million habitants. The estimated population now living in this territory is 3.6 million.

As of 1998, **61 per cent of the population was at a poverty level**, defined as income permitting a family of four to purchase less than two-thirds of a defined consumer basket of basic needs. In the Federation, about a quarter of the people below the poverty level thus defined were employed. Average net salaries in the business sector could buy only about 68 per cent of the consumer basket and about 87 per cent in non-business jobs. Only employees in financial institutions and public administration earned enough to be at or just above the poverty line. Both the pension and the unemployment compensation systems were in deficit and paying late and below the minimums.

Average daily income for impoverished persons was so low that they survived on financial support from relatives in the country, relatives and friends living abroad, international humanitarian assistance and activities in the shadow of unofficial economic activities.

According to statistical data of the UNDP "Early Warning System", in Bosnia-Herzegovina for the last quarter of 2000, "in the Republika Srpska (RS) the number of households with revenue under 100 KM doubled. Now it is as high as 15.6% of households... Four member families in B-H must earn a monthly income that exceeds 1000 KM in order to be above the poverty line. This amount of income would ensure 4\$ spending per day per household member. In the Federation (FB-H), 12.5% of the population have achieved this level, while in RS this percentage is only 4.3%.

Therefore, it does not come as a surprise that 55.3% of the citizens are ready to join a protest or strike because of insufficient income."<sup>2</sup>

Official statistics record quite impressive GDP growth rates: 21 per cent in 1995, 69 per cent in 1996, 30 per cent in 1997 and 18 per cent in 1998. But GDP had fallen to such a low level during the war that the increases achieved since are proportionately high as percentages of a small base. The country produces much less than before the war. Many pre-war production capacities have not been repaired or replaced or are hardly utilized.

Recent GDP growth is predominantly **aid-driven**, as reflected in the balance of payments. **The current account deficit in 1996** amounted to almost half the nominal GDP, declining to about one-fifth in the first half of 1999 in the Federation. Only about 25 per cent of imports were met by exports in the first five months of 1999 in both the Federation and the Republic.

The World Bank has predicted the level of export for the end of 2000 to be as high as \$ 1,816 million. In practice export has reached the level of \$ 1100. On the other hand, World Bank predicted import value to be \$ 2,863 million at the end of year 2000. Instead, import value amounted to approx. \$ 3200. Therefore, the trade balance

---

<sup>2</sup> UNDP, *Early Warning System*, October-December, 2000, p.26

deficit reached 4,402 million KM (or roughly \$ 2100 million). In 1999, the trade deficit was 4686 million KM or roughly more than 52% of GDP.<sup>3</sup>

From the perspective of economic development of B-H the structure of GDP deserves particular attention. In 1998, the power and industry sector participated in total GDP with 21%, having produced a value of KM 1156.7 billion. Trade sector participated in GDP with KM 903.9 million. In 1999, the power and industry sector participated in GDP of B-H with KM 1850.7 million and the trade sector with KM 1237.3 million.<sup>4</sup>

The obvious conclusion that can be drawn from such data is that:

- a) the industrial structure and production in B-H is in a state of deconstruction, and
- b) the trade sector is in a state of expansion, particularly foreign trade. Therefore, a huge trade deficit is a function of such economic relationships.

### 3.2. Determining Factors of Economic Deconstruction

When considering the development strategy and its effects so far, one has to take into consideration relevant external and internal factors of both an economic and a political nature.

Two external factors have determining influence. The first is the process of globalization of the world economy, and the "Washington Consensus" which provides the basis for the treatment of transition countries and their transformation into "small open economies." The other is the 1995 Dayton Peace Accord.

While the Accord placed banking and customs regulation at the central state level, fiscal policy was transferred to the entities and cantons, and no instruments were provided for shaping country-wide macro-economic policy. This ties the hands of the central state concerning the formulation of a uniform strategy for economic development, including industrial policy. In practice, Bosnia-Herzegovina lacks the power to formulate and implement independent monetary, fiscal, price and foreign exchange policies, and policies regarding privatization, incomes, and social welfare. Moreover, industrial policy-making is, in effect, impossible under the rules applied to the country by the World Bank and IMF.

The **development** prospects in such a poor country **are remote** since the starting position is so low. It has no developed market institutions and no strong government which might implement an alternative package of development and macro-economic policies. The policy package coming from, and implemented by, the IMF and the World Bank is seen as the only way of achieving stabilization, preparing the ground for privatization, and developing macro-economic policy under more favorable political circumstances.

Yet the evidence indicates otherwise. The "Frankenstein" economy simply does not perform as has been expected. An alternative supply-side approach to economic development strategy is clearly needed.

---

<sup>3</sup> According to UNDP data and Causevic, F. *Zaposlenost i privatizacija* (unpublished paper, Sarajevo, 2001) op.cit., p.17

<sup>4</sup> Causevic, F. op.cit. p.17

### 3.3. An Example of Frankenstein Economy: Inter-Entity Trade

Inter-Entity trade is relevant for B-H and its two entities for at least two reasons:

1. Economic, because its expansion can contribute to the growth of the GDP of the entities and of B-H, as well as to the more effective functioning of the market, and
2. Politically, because it acts or could act as an integrating factor of the political area of B-H, by stimulating cooperation between citizens and business people of both entities.

The significance of trade for economic growth and development of a country is beyond question. This goes both for domestic and foreign trade, especially in today's global environment. It should be that way for B-H, too.

It is therefore not surprising that some economists, entrepreneurs and politicians represent the position that trade is the integrating factor of economic and political recovery of B-H. In that respect an OHR effort was undertaken recently, concerning harmonization of special excises and taxes on the so-called "high-tariff" goods in the Federation (FB-H) and Republika Srpska (RS). With the same aims the office of the OHR has been pressuring ministers of trade of both entities to cooperate, to harmonize conditions for trade, to organize trade and finally, to exempt it from various formal and informal restrictions.

Until June 1998 inter-entity trade was regulated by the entities and was similar to, or even had more characteristics of international trade than of domestic trade. It is therefore perfectly normal that only a very modest volume of inter-entity trade was officially registered. Political policy bodies of both entities have had a more complete picture of inter-entity trade, since they monitor it closely in the given political circumstances.

Still, a logical, although (at first glance) paradoxical question is: would inter-entity trade have developed without pressure from OHR, and if so, to what extent? Similar relevant questions are the following:

- i. Is trade in B-H really an integrating factor for B-H, at least to the extent expected by the politicians and the office of OHR?
- ii. Does favoring inter-entity trade stimulate greater trade diversion than trade creation?
- iii. Under which circumstances can inter-entity trade create (intensify) the trade creation effect in order to be an integrating factor of the economic and political area of B-H, and in order to play its standard (textbook) role in the interest of B-H citizens and entities?
- iv. Thanks to the war and the Dayton Accord, B-H today is not even a firm customs union. The process of disintegration of the former Yugoslavia has led to creation of independent states, which have their own economies, and naturally, their own policies on economic relations with other countries. All except B-H. It is well known that, according to the Dayton Accord, B-H has special relations with its neighboring countries. These relations are so special that B-H for all practical purposes can hardly be said to have a unified customs system. B-H finds itself in the unusual position of having and not having of policy of economic relations with other countries.
- v. Her entities cooperate with the neighboring countries based on the principles of free trade zone. Given the fact that there were no customs or other obstacles to

trade with neighboring countries, and, on the other hand, given the existence of regulatory obstacles which obstructed trade between the entities until June 1998, it was completely natural that trade was created between the entities and their immediate neighbors, i.e. between Republika Srpska (RS) and Yugoslavia, and between the Federation (FB-H) and Croatia.

Aside from the reasons provided in Dayton, this process of creation of trade with neighbors and diversion of trade between entities has, to some extent, its "natural" reasons after the war.

The rationale of developing the effect of trade creation with the neighbors is based on import needs of both RS and FB-H. The economy of B-H and its entities, devastated by the war, had to satisfy its needs with imports. An edge was given in this process by the very nature of things, both as a consequence of the previously formed interdependency of the republics of former Yugoslavia, and due to the Dayton Accord and Dayton provisions.

Leaving aside the political considerations (which are still significant under B-H circumstances), we come to the most important question concerning inter-entity trade. The question is the following:

- vi. Does inter-entity trade determine economic flows in B-H, or is inter-entity trade itself determined by
  - a) the state of the economy in B-H,
  - b) solutions provided by the Dayton Accord, and
  - c) the Neo-liberal economic development strategy prescribed by the IMF, the World bank and supported heavily by the international community?

The economy of B-H is far less developed than the economies of the neighboring countries. In addition, the special relations make the import of goods into B-H from these countries a very simple matter. Under such circumstances, a rational entrepreneur has no logical reason for inter-entity trade. The trade diversion effect thus suppresses the trade creation effect!!!

The Neo-liberal concept for development of the economy of B-H eliminates state intervention in the economy, the infant industry argument, and foreign trade policy. At the same time, the convertibility of currency and a liberal foreign trade sector (with deconstructed domestic production) provokes a rational entrepreneur to import products from third countries, thus increasing the balance of payments deficit of B-H and its entities respectively.

The question is this: how long can this endure without support of the international community? What is the prospect for inter-entity trade without import from third countries?

These questions lead us to the theses that B-H must have its economic borders, but only if the necessary precondition is achieved in the form of dynamic economic development. Dynamic economic development can hardly be achieved by the current development concept.

#### **4. Economic Development of B-H: unresolved issues**

If we accept the above thesis, we might to continue to consider the future of B-H, and try to answer some relevant questions, such as:

- 4.1. Can B-H have its own strategy of economic development if its central bank functions as a “currency board”?
- 4.2. Can B-H follow a rule of “hard budget” constraints without inflow of fresh capital for productive purposes (recalling the case of the USA in the 1980's)?
- 4.3. How can B-H have a convertible currency with almost non-existent exports and production (recalling the case of the British pound in 1947)?
- 4.4. Is it possible for B-H or a small country in general to be a “small open economy”, without being internationally competitive (recalling the case of Japan or South Korea)?
- 4.5. What are the social and economic costs of the policy of a convertible currency introduced by decree (the case of the British pound in 1947)?
- 4.6. Is it possible for a small country to build and develop its own strategy for economic development under the conditions of the global world economy? If the answer is no, what are the consequences for this country?
- 4.7. Is it possible for a small country to have its own “offer curve” representing her own comparative (but not competitive) advantage in a world economy dominated by multinational companies?
- 4.8. Do we need a complete restructuring of economic theory and policy, and economic vision of the future world if our aim is a post-communist country restructured and properly integrated into new world economic system?
- 4.9. Or, are we faced with misery, social unrest and tragedy in post-communist countries (recalling Solzhenitsyn's book “Russia in the Chasm”)

We consider that the future of B-H depends to a large extent upon finding the right answers to these questions, otherwise B-H might be divided into three parts and disappear from the world political map.

## **5. New Orthodoxy – as a Theoretical Base for the B-H Transition Process**

The package of economic reforms for transition, both for Eastern European countries and for B-H, is based on several (at first sight) logical postulates – so logical to understand that their implementation also seems logical. The package is homogenous, based on the principles of neo-liberal mainstream economics. The “invisible hand” of Adam Smith is the core of the package, together with a presumption that the market mechanism functions perfectly. As such, the package, it is believed, optimizes both the welfare of the individual and the welfare of the society as a whole.

The fundamentals of the “standard package” are as follows:

- a) speed of implementation. The sooner the package is implemented, the better for society;
- b) openness of the national economy/liberalization of the external sector;
- c) export ,as an engine for economic growth;
- d) convertibility of currency;
- e) restrictive monetary policy and NIRU hypothesis;

- f) financial discipline following the rule of “hard budget constraints”;
- g) the role of the state is limited to the creation of a healthy macro-economic climate and the creation of the institutions needed for a market economy;
- h) replacement of inefficient and big state firms by SMEs;
- i) privatization of state property as a fundamental element of the package, to be carried out as soon as possible;
- j) absence of any coherent industrial, foreign trade or income policy. A state role in economics and Keynesian type of economic policy is considered to be inconsistent with the package.

## 6. The “Washington Consensus” in the B-H Economy

### 6.1. A Basic Strategy for Recovery

In the chapter “Towards Establishing a Market Economy” in the document “B-H Towards Economic Recovery” prepared by the World Bank, European Commission and EBRD, a basic strategy for recovery and the role of government was set forth.

The package contains all the elements of the theory and practice adopted in the East European countries. The exception to this, a very important one which was unnecessary in other East European countries, concerns the physical reconstruction of B-H. The issue of the physical reconstruction of B-H relates to the field of infrastructure, and has nothing to do with industrial restructuring. Industry should be started from scratch and based on new industrial facilities and industrial organization.

The World Bank document states:

“The basic strategy for economic recovery should rest upon the private sector as a main starting device of the growth of the economy and employment. Further, most of medium-term economy growth will have to come from the extension (the development) of the service sector and the development of light industry on the basis of private enterprises. The property now held by state firms which do not operate can be used by the private sector. What is needed here is to identify the useful parts of the state firms and to sell them through a simple and quick mechanism of privatization.”<sup>5</sup>

Therefore, a quick privatization, the dismantling of state firms, the development of SMEs along with light industries and the service sector were supposed to be levers for the growth of the B-H economy in the coming period.

The World Bank continues:

“The role of the state in the economic and development strategy which is governed by the private sector is not unimportant, but it is of shifted focus. It should concentrate on the maintenance of healthy macro-economic conditions, on the establishment of a relevant legal and institutional framework, which motivates uninterrupted functioning of a free market and provides basic public goods and social services, such as defense, public order, education, and health service.”<sup>6</sup>

<sup>5</sup> World Bank, European Commission, EBRD, *Bosnia and Herzegovina on the Road to Recovery*, 1996

<sup>6</sup> World Bank, *ibid.* p.XXIII



The reform of banks and firms is a major project which must be implemented in B-H. Sizeable inherited bad credits, as well as old foreign currency accounts must be excluded from the balance sheets of banks. At the same time, large and inefficient state firms must be closed or restructured.<sup>7</sup>

A special problem has been created by issues of numerous claims on the Government, including the claims of individuals (unpaid wages and pensions, restitution for post-war nationalization, claims pertaining to frozen foreign exchange deposits.)

“A great many individual claims could be dealt with by exchanging them for privatization certificates (vouchers) which, together with cash, could be used for transactions during the privatization process.”<sup>8</sup>

Regarding the institutional structure of the B-H state, the World Bank has argued that the most appropriate approach may be a flexible process for the restructuring and privatizing of firms and banks on a regional basis. In line with this approach, the privatization programs should have been applied regionally (i.e. on the level of Republika Srpska and on the level of a cantonal group, an individual canton or on local levels, within the Federation)<sup>9</sup>

## 6.2. Macro-economy of the Economic Recovery of B-H

The World Bank has stated that the stimulus for economic growth will come from the reconstruction process, and not from exports, as has been the case in East Europe. The macro-economic policy of the 2-3 year transitional period must be different, therefore, from the standard one. World Bank experts were of the opinion that the main macro-economic challenge of the transitional period (reconstruction period) is management of the great influx of donations and favorable credits, the removal of bottlenecks during the reconstruction period, and control of inflationary pressures. Maintaining macro-economic stability, however, is considered a key issue for successful recovery and for progress and development later on.

Under the World Bank and the IMF program, the Central Bank of B-H was supposed to have a foreign governor for the next 6 years. Monetary policy was to be restrictive and carried out by a currency board regime.

B-H was supposed to be integrated into international markets as a “price taker” with a fixed exchange rate of national currency pegged to the DM. In practice, this meant that the prices in B-H could not deviate from the German (world) price level.

The country is, thereby, losing the potential advantages of the effects of the so-called “Philips curve”. Monetary policy, one between the strongest instruments of macro-economic policy, has virtually being taken out of hands of the B-H authorities, since:

- a) the exchange rate of the national currency is fixed. However, in time, some problems of national currency management will appear as a result of price increases on the one hand, or the large influx of capital, on the other hand. For the

---

<sup>7</sup> World Bank, *ibid.*

<sup>8</sup> World Bank, *ibid.*

<sup>9</sup> World bank, *ibid.*

time being, from the time the Dayton peace accord was signed, that question had to be put aside, particularly as the country did not have a single currency, but rather four different currencies: the Dinar, Kuna, Serb Dinar and DM. Additionally, at that time, no-one could trust the domestic nationalist-oriented politicians.

- b) The “hard budget constraint” is a rule which B-H authorities had to accept in the package. A budget deficit cannot become a source of inflation.

## **7. The Controversies of the Transition Package**

### **7.1. The Duration and Speed of Transition**

East European countries were supposed to be transformed into modern market economies. Some of them were more successful at this, some less. In the main, however, only three countries so far reached and exceeded the level of GDP they enjoyed at the start of the transition process (Poland, Hungary, Slovenia).

Ten years have already passed, and it comes as no surprise that J. Sachs wrote in 1996: “I do not think that 500 days (as was imagined for the Russia transition by the Stalin Plan) is enough to convert what is now a Soviet Empire into a market economy. They are too far away from that to have a radical transition in 500 days. From my own point of view, if this becomes a general blueprint for a 5000 day transition - it would be miraculous enough for success.”<sup>10</sup>

### **7.2. The External Sector: Liberalization, Export as an Engine for Growth and Development, Convertibility of Currency**

The role of the external sector in the process of transition of former repressed (non-market) economies has been accorded significance by the World Bank. The IMF and several well-known economists recognized that there are controversial issues based on lessons of experience and alternative models.

For example, J. Sachs draws on the experience of South East Asian countries. He remarks that the new orthodoxy defines the policy content of outward orientation to include the following measures:

- a) trade liberalization,
- b) elimination of quantitative restrictions through the legal system,
- c) adoption of uniform tariffs,
- d) real exchange rate,
- e) an emphasis on the private sector as a source of growth and general reductions in all forms of market intervention by the government.<sup>11</sup>

J. Sachs makes the additional point:

“... at the very least, the strategy can find little historical support. The success stories of East Asia do not demonstrate utility of trade liberalization in the midst of macro-economic crisis. The real historical cases of liberalization during a macro-economic

<sup>10</sup> Sachs, J. *Trade and Exchange Rate Policy in Growth Oriented Adjustment Process*, IMF, 1987, p. 291

<sup>11</sup> Sachs, J. *ibid.* p. 292

crisis are the Southern zone countries (Argentina, Chile and Uruguay) during the 1970s and these episodes are well-known debacles, in part because of the conflicting requirements of stabilization and liberalization.”<sup>12</sup>

Dealing with the relationship and interdependence between trade and growth, a relationship very important for the former socialist countries during the process of transition, Cambridge university M. Panic says: “it is debatable whether the liberalization of commercial policy was one of the causes rather than consequences of the extraordinary success of Western European countries in rebuilding their economies. Trade policy seems to be determined to a considerable extent by relative levels of development and international competitiveness. This observation is consistent with the proposition that the performance of leading industrial countries in the period of 1950-1969 can be easily explained in terms of exports led by growth rather than growth led by exports.”<sup>13</sup>

Let us here recall a historical case.

After World War II, the USA proposed to Western Europe a complete transition strategy consisting of macro-economic stabilization, price reform, liberalization of foreign trade, but without privatization. The starting position of Western Europe was to a great extent similar to the position of Eastern Europe since the beginning of the transition process, except that the countries of Eastern Europe had to take the revolutionary step of privatizing state assets as soon as possible. Practically speaking, the problem of Eastern Europe has been much more complicated than was the problem of Western Europe after World War II.

The B-H problem, and this should be emphasized, is even more complicated than that. Because this country has been suddenly faced with a triple transition:

- a) transition from war to peace,
- b) transition from socialism to a market economy,
- c) transition from rebuilding and reconstruction of the country towards a market economy.

“Despite visible evidence to the contrary, the belief of the USA was that Western Europe could accomplish recovery in a matter of a few years thus enabling the vision to become a reality. Western Europe was expected to liberalize its external trade and payments as soon as possible, irrespective of its economic and political circumstances.”<sup>14</sup>

The example of post-war reconstruction of the UK is of interest here. The USA granted to the UK a large loan in 1945 under two specific conditions: that the pound should be made convertible within a year and all discrimination against USA exports be abolished by the end of 1956.

The convertibility of the pound was introduced in July 1947 and ended abruptly in the following month, by which time most of the \$ 3.5 billion of the loan has been used to satisfy the demand for USA dollars at the existing exchange rate.

---

<sup>12</sup> Sachs, J. *ibid.*

<sup>13</sup> Panic, M. *Managing Reform in the Eastern European Countries*, p.32

<sup>14</sup> Panic, M. *ibid.* p.13

“Given the relative strength of the two economies and currencies, the most surprising thing about this episode is that anyone could have expected a different outcome.”<sup>15</sup>

“From a global point of view, liberalization might be defended not as in the interest of the initiating country, but rather in the interests of the rest of the world... Some of the US pressures for liberalization in the developing countries (Brazil, Korea, Mexico) indeed emanate more from concerns about US trading interests than from concerns about the welfare of the developing countries. To the extent that this is the real motivation for pressures for liberalization, however, it makes little sense to press poor countries in dire economic difficulties to make rapid structural changes on behalf of the rest of the world.”<sup>16</sup>

### 7.3. The Respective Roles of Large and SMEs

The economies of the 20<sup>th</sup> and 21<sup>st</sup> century have a different background from that of Adam Smith’s economy. Nevertheless, the position and role of SMEs in the contemporary world, and especially in developing countries, deserve special attention. The ideology of neo-liberalism stresses the role of SMEs as promoters of a “healthy” business climate and economic efficiency, and, therefore, they are of special importance for the economic growth of less developed countries (LDC) and countries in the process of transition.

For B-H, as a country of “specific specifics”, or very special particular conditions, given its devastation from war and the need for reforms and war reconstruction, the role of SMEs has never been more important.

According to Ranier Vanni d’Archirafi, SMEs are the cornerstone of the economic recovery of the former EEC. This was due to the fact that of 15.7 million enterprises in the EU, 99% are SMEs. Of that number, 14.5 million enterprises have fewer than 10 employees. Some 50% of enterprises are one-person enterprises. SMEs account for more than 50% of the investments in the EU and 60% of the GDP of the EU.

To avoid facile conclusions, however, especially those which may be one-sided (i.e. the World Bank suggests it would be a good idea to break up big companies), one should nevertheless consider the following point. If SMEs comprise 99% of all enterprises in the EU, and provide 60% of the GDP and 50% of investments, then it follows that the 1% of big companies still provide 40% of the GDP and 50% of investments in the EU.

The donations and credits which are provided by the EU for SMEs constitute an important and impressive activity, directed towards stimulation of economic development and implemented mainly through the channels of the Structural Fund. The basic aim of this activity is assistance for the economic development of certain regions of the EU. A sum of 150 billion ECUs for the period 1994 to 1999 is available to the Structural Fund, the resources of which are directed in the first instance to the national governments and not directly to the SMEs. Those resources are used to stimulate the economic growth of areas of slower development (Portugal, Spain, Ireland), the industrial restructuring of enterprises, education, and human capital and rural development.

---

<sup>15</sup> Panic, M. *ibid.*

<sup>16</sup> J. Sachs in *Growth Oriented Adjustment Process*, IMF, 1987, p.294.

The activities of the EU in the sphere of SMEs development clearly show the following features:

- a) SMEs are important complementary factor of economic growth in the EU;
- b) The EU (the State) takes care of regional development;
- c) The EU has a special Fund for that purpose;
- d) SMEs were not developed in the EU autonomously and without coordination with other important decisions and interests of economic development.

If that is the case, how then can small, poor B-H - a country without capital, without adequately developed entrepreneurial initiative and without an organized state, expect SMEs to become important promoters of economic growth to the extent that the large companies, which have been generators of the country's economic growth since World War II, can suddenly be privatized and divided up (eliminated)?

This appears to go against the historical evidence of the contribution of large enterprises and government direction of economic development (take for example the case of South Korea and the role of Korea's "big" companies in promoting economic development. Japan is even more a case in point).

## 8. Privatization

Privatization is still the "alpha and omega" of all transition packages despite some questions as to its success in eliminating de facto state control.

So-called "coupon privatization" was intended to directly confront the problem of the lack of internal savings, and the solution adopted in the Czech Republic was considered to be the most successful example of this method in this time.

Today, the majority of international privatization experts consider the Czech case to be a disaster.

Still, B-H relies heavily on such a method of privatization.

Several years ago Mertlik concluded that voucher privatization, the main purpose of which is to solve the problem of absentee ownership inherited from the command economy, resulted in a "large-scale and long-term institutionalization of absentee ownership"<sup>17</sup>

In the case of the B-H economy, there are additionally two "Frankenstein" issues concerning privatization.

Privatization in B-H has been supported, even by the World Bank and the IMF experts as an Entity privatization. The property of B-H as a state has, thus, been partitioned into two parts: the property of the state of RS and the property of the state of the Federation. Such a solution has contributed seriously to the further division of an already divided B-H economic space. It has contributed to the development of Inter-entity trade and to the confusion of citizens.

Furthermore, in the specific B-H case of having three ethnic groups (Croats, Bosniacs and Serbs), privatization along the proposed lines has been contributing to creation of so-called "ethnic privatization". That is, the Bosnia oligarchy gets the companies in the region dominated by Bosniacs, Croats in the region dominated by

---

<sup>17</sup> Mertlik, L.K. *Lessons to be Drawn from Main Mistakes in the Transition Strategy*, The Vienna Institute for Comparative Studies, p.21

Croats. In RS, Serbs are anyhow the dominant part of the population. To add to this, employees are then selected on the basis of ethnicity!!!

Additionally, the idea that state companies should be: a) first privatized, and then b) afterwards restructured has delayed the restructuring process indefinitely. In the meantime (5 years later) state-owned companies, waiting to be privatized on this most inappropriate and mostly impossible way, become:

- a) technologically more obsolete,
- b) unproductive and loss makers
- c) irresponsible both to the government and to themselves,
- d) "asset stripping" takes place. State companies become a source of capital and profit for new private companies. Inter-company income distribution also takes place.
- e) Now state companies represent the problem that they cannot be easily sold, or even sold at all.
- f) Another serious question for both domestic authorities and the international community regarding privatization will soon become apparent: what to do with non-privatized companies?

In the middle of the year 2000, the new governing board of the Cantonal Agency for Privatization Sarajevo, having in mind almost all of these issues, proposed to the international community the following outline of a new privatization law.

### **8.1. Outline of a New Privatization Law**

In order to coordinate the concept of privatization with economic development

A Privatization Tender Bureau should be established on the level of B-H as a state. (Privatization Tender Bureau Bosnia-Herzegovina - PTBB),

The PTBB might be connected with local privatization agencies in the process of privatization, because of political reasons.

The PTBB should monitor local agencies.

A B-H Development Fund should be established for B-H as a state. The Fund should be in charge of:

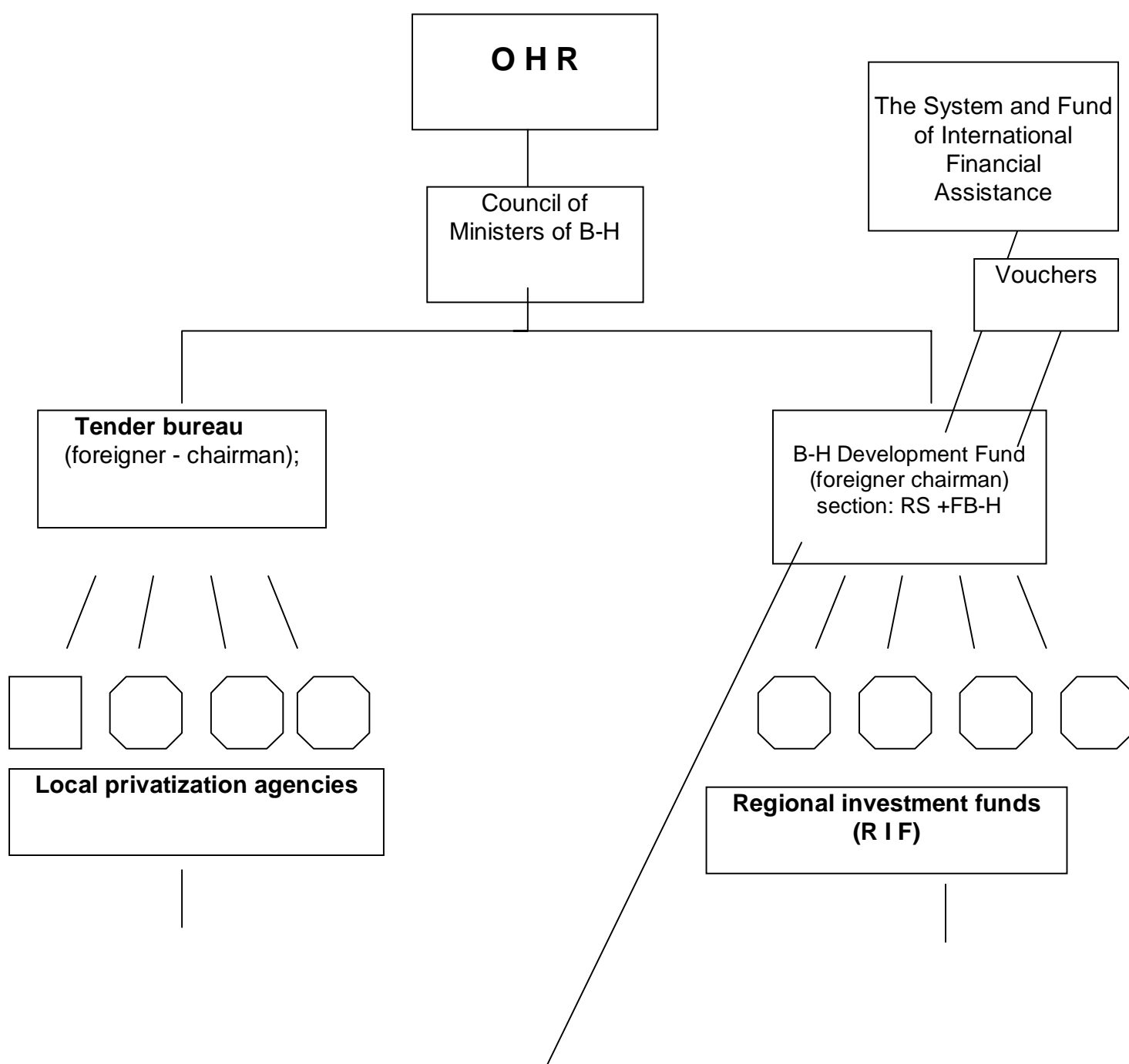
- a) Coordination of the economic recovery program, and
- b) Coordination of Regional Investment Funds (RIF) that could be created.
- c) The RIF should pick up all existing vouchers (except those relating to frozen foreign exchange savings and restitution, if we resume voucher privatization). RIF together with the Fund would invest vouchers in companies which will work on both the regional and national (State) level. Regions could be created such as, for example, a Central Bosnian region, North-eastern region, North-western region, Herzegovina region, etc. This is how the ethnic effects of privatization could be resolved. Alternatively, with the already created PIF, those funds could be ordered to structure their portfolio on such a way so as to avoid "ethnic" privatization.
- d) Economic recovery funds (capital) should go into the Development Fund. Capital from the Fund would be distributed to viable and healthy companies under the conditions specified by the Fund.

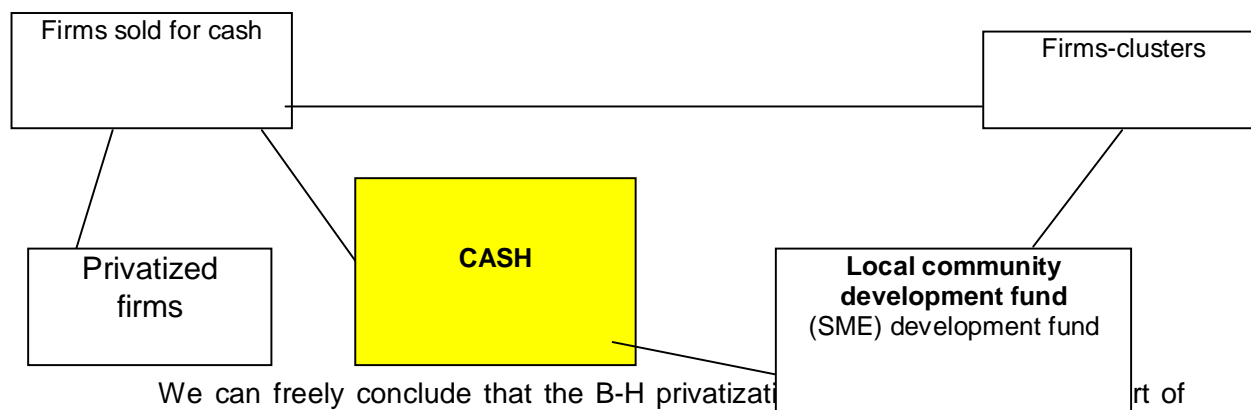
- e) The Fund is established by the office of OHR. The Fund has a chairman who is a foreigner. Other members are domestic experts not belonging to political parties, or at least not belonging to nationalist political parties.
- f) Regional Investment Funds are constructed on the same principle.
- g) Dividends will not be paid for at least 3-5 years, starting from the date a company becomes functional and profitable. The idea is to keep capital within the company.

Unfortunately, this outline has been accepted and supported only partially by the "international community" - some countries did not want to consider the outline, with the excuse that privatization has already gone too far.

Had it really, as of the middle of the year 2000?

In addition, those who opposed this outline stated that such a concept would mean reaffirmation of the state and state institutions in the economy.





We can freely conclude that the B-H privatization is a part of the entire transition process and will have far-reaching consequences upon the further economic and social development of B-H. The basic problem is that this privatization is disconnected from the process of economic development.

## 9. The Role of the State in Economic Development

Under the neo-liberal approach, it is clear that the state is expected to have an ever-decreasing role in the transition process of former socialist countries. The state is considered as a “counter-productive player” in the modern market economy and according to all packages of transition created so far, its role is reduced as much as possible.

9.1. In the B-H reality, the position of the state is even less recognized as a positive player in the process of economic development.

B-H, as a state, does not have the authorities listed below which are necessary to play a meaningful role in economic development:

- a) an independent monetary policy (B-H is under a currency board regime),
- b) an independent fiscal policy (the country consists of two entities with different fiscal regimes),
- c) its own price policy (the rate of inflation differs significantly in the two entities),
- d) an independent foreign exchange rate policy. (For this reason the country has no possibility of using devaluation of currency in order to adjust its foreign exchange rate)
- e) a privatization policy (different policy in the two entities),
- f) an income policy,
- g) a social policy (the state is organized/disorganized, and is not able to conduct a unified social policy).

All of this means that B-H does not have good chances for a spontaneous development based on private initiative and a free but unorganized market and market institutions. B-H is a good example of the adoption of a more liberal concept of economic development than that which was adopted in the period of the Gold standard.

It is maintained that the macro-economic package of the World Bank is the only real solution for the achievement of a policy of stabilization and preparing the ground and the conditions for the process of privatization and for developing macro-economic policy under more favorable political circumstances.



Yet, the evidence is to the contrary.

B-H has achieved a so-called “nominal convergence” with other transition countries, and even to some extent with the EU. The country enjoys:

- a) a stable and convertible currency (KM),
- b) the foreign exchange rate is stable,
- c) inflation is almost nonexistent.

On the other side of the coin, the country is faced with:

- a) a dangerously high level of unemployment,
- b) an unsustainable level of balance of payments deficit,
- c) an unsustainable level of foreign debt
- d) industrial capacity operating at 30% of its pre-war capacity.

The country is far from any “real convergence” with the most promising transition economies, let alone with the EU.

Basically, we could state that the country could be classified as an “aid-driven economy”. As such, the country is below the first stage of economic development defined by M. Porter as a “factor-driven economy”.

## **9.2. Stages of Economic Development and the Role of the State: Lessons offered by M. Porter**

According to M. Porter a country normally passes the following stages of economic development:

- a) Factor driven stage
- b) Investment driven stage
- c) Innovation driven stage
- d) Wealth driven stage.

As did his predecessor Adam Smith, M. Porter underlines that it is not inevitable for nations to pass through these stages. But, if a country becomes entangled in what Adam Smith called an unnatural order, lessons will have to be learned and a price paid. So, let us see what the differences are between the stages of economic development as described by M. Porter.

Factor-Driven stage:

“In nations at this initial stage, virtually all internationally successful industrial branches in the nation draw their advantage almost exclusively from certain basic factors of production. In the “diamond” only the factor is an advantage. A nation's firms in such an economy compete solely on the basis of price in industries that require little production or process technology that is inexpensive and widely available. Technology is sourced from other nations and not created... Foreign firms provide most of the

access to foreign markets... A factor driven economy is one with a poor foundation for sustained productivity growth.<sup>18</sup>

#### Investment-Driven Stage:

"In this stage, national competitive advantage is based on the willingness and ability of a nation and its firms to invest aggressively... technology is typically a generation behind international leaders. In this stage, however, foreign technology and methods are not just applied but improved upon.

Very few developing nations ever make the jump to this stage. In the postwar period, only Japan and more recently Korea have succeeded. Taiwan, Singapore, Hong Kong, Spain and to lesser extent Brazil are showing signs of achieving this stage."<sup>19</sup>

#### Innovation-Driven Stage:

This stage is called innovation-driven because firms not only appropriate and improve technology and methods from other nations but create them... The innovation-driven stage marks the onset of significant foreign direct investment. Industries are less vulnerable to cost shocks and exchange rate movements because they compete in technology and differentiation. Globalization of firm strategies also provides a buffer against such fluctuations.

#### Wealth-Driven Stage:

The wealth-driven stage is, in contrast, one that ultimately leads to decline. The problem is that an economy driven by past wealth is not able to maintain its wealth.<sup>20</sup>

### 9.3. Stages of Economic Development and the Role of Government

The Washington Consensus negates any role for the government both in transition and less developed countries (LDC). Even the institutions of a market economy are forgotten. It has been assumed that the magic wand of the free market and foreign direct investment is enough strong ammunition for economic progress (according to the IMF, the World Bank, WTO etc., and for a great many others, particularly domestic professor of economics). Is this really the case?

The historical lessons on this subject are well known.

M. Porter is the father of a theory which explains the competitive position of transnational companies (TNCs) in the global world economy. The more a country has internationally competitive TNCs, the more that country is competitive, and the more wealth is created in that country.

With regard to the role of government versus that of the market, Porter would appear to support a solution that negates a serious government role. Is this really the case or perhaps not? And, what are the implications of such an eventual

---

<sup>18</sup> Porter, M. *The Competitive Advantage of Nations*, 1990

<sup>19</sup> Porter, *ibid.*

<sup>20</sup> Porter, *ibid.*

misinterpretation of Porter's economics for the future of transition economies and less-developed countries? Let us quote from Porter on the role of government.

"Government has the greatest direct influence on national advantage in the factor-driven and investment-driven stages. The tools at its disposal, such as capital, subsidies, and temporary protection, are most powerful at these stages in a nation's competitive development... Government at this stage can play an important role in such areas as channeling scarce capital into selected industries, promoting risk taking through explicit or implicit guarantees of assistance, stimulating the acquisition of foreign technology and employing temporary protection to foster entry leading to domestic rivalry and construction of modern facilities... Devaluation will also only be beneficial in the early stages, when the nation's firms are still dependent on competitive prices to penetrate foreign markets.

As the nation aspires to move beyond these early phases, driven by investment and innovation, however, the firms must increasingly become the prime movers... Government's role must shift almost exclusively to an indirect one... The government's essential task at the innovation-driven stage is to create an environment in which firms are and continue to be innovative and dynamic... At the same time as a nation's firms become larger and more global, they become less affected by domestic macroeconomic factors and less amenable to government persuasion..."<sup>21</sup>

Now, should we address ourselves to the following questions:

What is the stage of economic development that B-H is in?

What is the role of the market at that stage?

What should be the role of government at this stage?

What is the role of foreign direct investment during the stage of factor-driven or investment-driven economy?

Can we pass from our stage of economic development to a higher one relying on the dogma of free market and foreign direct investment? And, what do we do if we cannot?

## **10. The Role of Foreign Direct Investment (FDI) in the Process of the Economic Development of a Transition Economy**

One of the most seductive flaws of the transition package is excessive reliance on Foreign Direct Investment. Experience of transition countries gained so far, as well the historical experience of different Latin American countries, has shown that not enough foreign direct investment goes even to those markets which are politically stable and which are the most advanced in the transition process. For example, according to EBRD (European Bank of Renewal and Development) data, Malaysia has had more foreign direct investment than all the East European countries put together until 1997. Along with the amount of FDI, comes a more important question regarding the future of those countries which try to rely almost exclusively on foreign direct investment in order to promote their economic development because of:

- a) lack of capital,
- b) lack of management,

---

<sup>21</sup> Porter, *ibid.*

- c) lack of technology,
- d) lack of foreign markets.

But, there may arise here a risk which goes hand-in-hand with an increasing role of multinationals in a domestic economy.

“Foreign multinationals are an important part of the process of economic development, particularly in the earlier stages. They cannot ultimately be the sole engines for creating national advantage in advanced industries... A development strategy based solely on foreign multinationals may doom a nation to remaining a factor-driven economy. If reliance on foreign multinationals is too complete, the nation will not be the home base for any industry.

Foreign multinationals should be only one component of a developing nation's economic strategy, and it should be an evolving one. At some stage in the development process, the focus should shift to indigenous companies. In Singapore and Ireland, my view is that the shift has been too little and too late.<sup>22</sup> Inbound foreign investment is never the solution to a nation's competitive problems. While intervention is counterproductive, except in the circumstances noted, widespread foreign investment is a sign that policy initiatives toward industry must receive high priority.”<sup>23</sup>

What M. Porter is stressing is that a developing country should rely on foreign capital in the form of foreign direct investment at the beginning of her development - when it is in the stage of economic development which he refers to as the “factor-driven stage”. If a country wants to enter the next stage of economic development, that is the investment-driven stage, let alone the innovative-driven stage, the country cannot succeed without having its own “home base” industry.

Home-based industry, in turn, cannot be developed, according to Porter, if the strategy for economic development and economic policy measures are not directed to the process of development of “home based” industries. As he says, “if reliance on multinationals is too complete, the nation will not be the home base for any industry.”<sup>24</sup>

Under such a circumstances, a dual economy develops within a country and a paradox of “opulence” comes out to the forefront of the national economy. On the one hand, an economy enjoys the benefits of multinationals celebrating an export increase. On the other hand, misery in the economy develops in “domestic sectors”. There is a danger that the overall productivity level of a nation will decline in the long run. The GDP of a nation can increase, but the GNP of that nation can decrease.

## 11. What to Do? / Possible Alternative Scenarios

**11.1.** The “Frankenstein economy” which was created by the Dayton Agreement, and which is not strongly supported by economic development and economic progress so far, could be revived and still divide B-H into three parts. This could be the economic consequence of the Dayton Peace Accord, from one side and the effects of the “Washington Consensus” type of economic and development policy, from the other side.

---

<sup>22</sup> Porter, M. *ibid.*

<sup>23</sup> Porter, *ibid.*

<sup>24</sup> Porter, *ibid.*

## 11.2. Strategic Considerations for B-H

When considering a possible strategy of economic development of B-H as a “small open economy”, one has to take into consideration relevant factors of both an external and an internal nature, as well as economic and political factors.

Of the external factors of a strategy for economic development for the country, and its macro-economic policy, there are two particularly important determinants:

11.2.1. The process of globalization of the world economy forces small open economies to be “price takers” and “rule takers” in the international economic arena.

In this situation the small open economy (SOE) has to follow the rules of the game which are today being laid down by huge multinational corporations.

The world is in a process of transition to full internationalization and globalization. Even today within the EU, the various schools of economic policy (Keynes, Monetarism and others) are not fully adapted to the emerging world economy and supra-national economic policy issues. In such circumstances the monetary and fiscal policy, and balance of payments policy likewise, of a SOE is subordinated to the rules of the game and conditions dictated by leading countries and leading multinational corporations.

11.2.2. By the Dayton Agreement the international community fixed the limits of the sovereign state of B-H. By the same agreement the state is divided into two entities: the Federation (FB-H) and Republika Srpska (RS).

## 11.3. Alternatives

After some revision of the Dayton Agreement in the sense of forming a “normal” country with standard economic prerogatives, an alternative solution could be built around the ideas, analysis and prescriptions of the standard “package” and correction of the errors in it which we have covered thus far.

First of all, the process of privatization should not have to be performed “overnight” regardless of the cost. An early idea was to get rid of the vouchers. Unfortunately, at this moment we are already late. Unfortunately, we are likewise significantly late in restructuring domestic companies prior to privatization.

In fact, the approach of the World Bank has forbidden restructuring of state companies before privatizing.

State companies could have been distanced, and can even today be distanced, from the state in the same way as the central bank is distanced from the state by means of a foreign governor. A team of top international experts could be found to facilitate reconstruction of enterprises and banks. This team could perform the function of an “imposed manager” for the duration of the process and until the large enterprises are on their feet again (at least some of them). Privatization would thus be easier, more profitable and more tolerable.

Big enterprises should have been supported, as the budget cannot cover all expenses resulting from massive unemployment. Even though a firm cannot cover its labor costs and might not be making a profit, it might be kept in existence. If the firm is not able to cover by the added value of its products even its labor costs, it is still

reasonable from the budgetary point of view to allow it to continue functioning and for its wage bill to be subsidized to the level of the unemployment benefits and social security payments which would be incurred if the firm were liquidated.<sup>25</sup>

In this case, social Darwinism is not accepted as a rule of the game in creating a better society for the future.

SMEs should be stimulated. Those firms that are not privatized could be effectively privatized by systematic measures and different modalities of privatization such as: leasing, management buy-out or by the issue of internal shares to the workers.

The state, with an active industrial policy, development funds, and an active trade policy, should direct development and not simply base it on the rather elementary principles for operation of the open market economy stemming from the works of Ricardo and Heckscher-Ohlin, which ignores the important distinction between dynamic theory and static realities. This is because these policies concentrate on the dynamic aspects of comparative advantage, which simply do not exist in the static theory of comparative advantage.

Something else which should be kept in mind is the fact that this country is not ready for a Theory of Competitive Advantages of Nations. B-H is in an "aid-driven" stage of pre-development, and should be directed toward the "factor-driven stage" of development.

Building of institutions needs to be recognized once again. This is simply because the institutions were forgotten at the start of the transition.

## **12. Balkan Economic Integration and the B-H Economy**

### **12.1. The Idea**

The International community, whatever that means, has offered an alternative method of economic development to B-H, and to the other Balkan countries. The Stability Pact is the alternative offered.

"The Stability Pact aims at strengthening countries in South Eastern Europe in their efforts to foster peace, democracy, respect for human rights and economic prosperity, in order to achieve stability in the whole region. Those countries in the region who seek integration into the Euro-Atlantic structure, alongside a number of other participants in the Pact, firmly believe that the implementation of this process will facilitate their objective."

The economic aspect of the Stability Pact could be summarized as the objectives of:

"Creating vibrant market economies based on sound macro policies, markets open to greatly expanded foreign trade and private sector investment, effective and transparent customs and commercial/regulatory regimes, developing strong capital markets and diversified ownership, including privatization, leading to a widening circle of prosperity for all our citizens."

"Fostering economic co-operation in the region and between the region and the rest of Europe and the world, including free trade areas."<sup>26</sup>

---

<sup>25</sup> Laski, K. *ibid.* p.23

<sup>26</sup> The Stability Pact, Internet.

## 12.2. The Arguments for the Stability Pact and Balkan Economic Integration

On the basis of standard, although not mainstream, economic theory, historical experience and the present state of affairs of transition economies as well, we can arrive at several conclusions:

1. Macroeconomic stability should precede the privatization process. Particularly in the regions such as: Croatia, Bosnia-Herzegovina and Macedonia for example, where the problem of unemployment, in addition to economic consequences, carries with it very serious ethical and political ones.
2. The privatization process is long-term process. It will take 10-15 years, possibly even more.
3. The privatization process is a very expensive one. The case of former DDR is clear enough. Transfer of funds from Germany into the former DDR has swallowed up approximately 150 billion DEM per year.
4. According to World Bank data, between 1980-1989, less than 1000 companies were privatized all over the world. The privatization process gained enormously in power and speed since 1994. Therefore, the process became more complicated and questionable from the standpoint of economic efficiency achieved in a transition country. There is a difference of history with regard to the privatization process which takes place in a mature market economy and one in a former socialist economy. In the latter case we privatize the whole economy and transform the whole political, social and economic system. This is a revolutionary move!
5. The privatization of state assets without the restructuring of those assets guarantees neither an increase of economic efficiency nor an increase of GNP.
6. Fundamental prerequisites for a successful restructuring of assets are the following:
  - a) capital,
  - b) improved management,
  - c) institution-building
  - d) time
  - e) market
  - f) adequate macroeconomics management.

Balkan countries have not met any of those preconditions! One of the possibilities to build at least some of those preconditions could be the creation of a regional economic integration similar to the one which helped Western Europe to eventually become an economic union.

Both historical experience and knowledge of economic theory speak against the possibility of a rapid, efficient and painless transition from a repressed into a small open economy. In practice, the newly created countries in the Balkan region have already introduced their own currencies and their own customs systems. They try to follow their own, independent, way towards a market economy. However, all of them are lacking capital, market infrastructure, and managerial experience. Their currencies are made convertible by decree. The countries usually run a serious balance of payments deficit, they have a budget deficit, they are faced with an internal lack of liquidity, high unemployment, and increasing poverty. Foreign direct investments are lacking in the

region and especially in countries like Croatia and B-H. Furthermore, these countries have a very limited market, a market which could hardly be attractive for foreign direct investment.

Therefore, one of the most important issues that faces the Balkan countries is:

Should they proceed with their independent ways towards economic development, paying no attention to the cost of such independent economic development or are these countries better off by joining each other in a way which could be similar to the one undertaken by Western European countries since the Second World War?

In the context of the need for rapid economic development in the Balkan region, the SECI initiative and the Stability Pact provide Balkan countries with an additional impetus for economic development.

### **12.3. The Stability Pact – an Economic Illusion and Empty Box**

The Stability Pact provides the framework for a bright and prospective economic development of the Balkan countries.

However, one may say that The Stability Pact is still only loosely defined in terms of the technicalities for a successful economic solution.

The Pact pleads for a free trade area, but it does not define that area more closely. The Pact would like to see the economies of the Balkan countries forged together, but it does not provide a ready-made answer regarding a practical solution. The Pact favors economic growth, as an unavoidable prerequisite for advancement of peace and democracy in the region, but it hardly gives any answers to the following questions:

- a) Should the member countries pursue a monetarist type of economic policy or should they resort to some Keynesian economic solution?
- b) Should countries respect the NIRU (non-inflationary rate of unemployment) hypothesis, regardless of the level of unemployment (unofficial unemployment currently in Croatia is 23% and in Bosnia-Herzegovina is close to 43%)?
- c) Should countries keep their currencies convertible regardless of the fact that conditions for convertibility are not fulfilled?
- d) Should countries keep their currencies pegged to the Euro in the form of a "currency board" type of pegging, paying no attention to the danger of the effects of deflationary forces?
- e) Should the member countries stick, generally speaking, to the rules of the so-called "Washington Consensus", or can they do better switching to the kind of developmentalism or supply-side economics for productivity, competitiveness and convergence as defined by professors Murakami, C. Pitelis, or to some extent J. Stiglitz?

Let us, now, mention the comments concerning the topic by J. Stiglitz and C. Pitelis, as follows:

J. Stiglitz:

"Yet China did not follow the dictum of the Washington Consensus. It emphasized competition over privatization: standard economic theory says both are



required for an efficient market economy. The Washington Consensus emphasized one; China the other. We see the track record. It should not be surprising... Privatizing a government monopoly is often likely to create a private monopoly with high prices and continued inefficiency... Topics left out by the Washington Consensus are perhaps even more telling: financial markets, competition and regulation, transfer of technology, development of institutions – to name but a few whose importance has been increasingly recognized.”<sup>27</sup>

C. Pitelis, Cambridge University:

“**Real convergence** (between EU and Southeastern European Countries) can be attained through different increases in productivity and (thus) competitiveness. In the medium term there is no other way. Macroeconomic policy can only contribute in the short run. A **nominal convergence** can contribute to macroeconomic stability, and it can also be putting things into place. However, this is insufficient, virtually by definition. Attainment of nominal convergence by all parties implies a comparative advantage for no-one. This emphasizes the importance of supply-side (industrial) policies for productivity, competitiveness and convergence.”

“Supply-side (industrial policy) in its more general sense can be any type of government policy which affects production. This could encompass all types of government policy, including macroeconomics. While the latter may strongly influence industry, here it will be taken as the background against which supply-side policies can be applied. In this setting we can define supply-side policies as government policies intended to affect production directly and specifically towards achieving a particular objective... Lastly, industrial strategy will be taken as the existence of a well-thought out and reasonably consistent and coherent set of industrial policies (along with required resources and mechanisms for implementation) which aim at realization of a long-term objective concerning industry in particular and, through it, the nation more generally.”<sup>28</sup>

## 12.4. An Alternative Approach to Balkan Integration

It seems pertinent to add to those comments the very detailed concept of Balkan economic integration provided by B. Horvat in his “The Theory of International Trade-An Alternative Approach”.<sup>29</sup>

B. Horvat builds his vision of Balkan economic co-operation starting from the creation of a customs union for member countries. The economic future of Balkan integration he forges on an economic paradigm very similar to Pitelis’ Supply-Side for productivity, competitiveness and convergence and to Murakami’s concept of “Developmentalism”.

The main benefits for both member countries and for outsiders that could be derived from such an integration (we will mention just a few of them) according to B. Horvat are the following:

---

<sup>27</sup> Stiglitz, J., In Laski, K. *ibid*.

<sup>28</sup> Pitelis, C. *Supply-side Strategy for Productivity, Competitiveness and Convergence*, PHARE-ACE project under way, 2001

<sup>29</sup> Horvat, B. *Theory of International Trade*, Macmillan, 1999

1. Increase of mutual trade of member countries and creation of a large market which makes possible specialization and other effects;
2. As the size of the market increases many times over, there is plenty of scope for economics of scale of all sorts;
3. The combined bargaining power of a customs union makes possible gains from terms of trade;
4. Large markets stimulate competition, which in turn stimulates efficiency. It also makes possible more intensive research and development which foster efficiency;
5. A larger and growing market makes it possible to solve more easily the problem of certain ailing industries (shipbuilding, steel, textiles);
6. Larger market and trade creation stimulates the fuller use of capacity and larger investment leads to a higher rate of growth. As a consequence, unemployment will be more readily eliminated;
7. A large market attracts foreign productive capital and reduces the brain drain;
8. There also exists an extremely important non-economic effect. An international union is conducive to greater international tolerance. The latter, in turn, helps in establishing greater internal democracy and, thereby, political stability.”<sup>30</sup>

### 13. Concluding Remarks

For some time from the beginning of the transition process of the former socialist economies it was believed by both:

- a) the indigenous people, that is, their politicians and a majority of their economic experts, and
- b) the international community's politicians and their most influential economic experts that the transition countries could manage efficiently and successfully their destiny individually, on their own.

The B-H economy and society 6 years since the time that the Dayton Peace Accord was signed is still in a pre-developmental stage. B-H is in a stage of economic development which could be referred to as an “aid-driven stage”.

It seems more and more obvious that an alternative solution is needed:

- a) for real convergence of B-H towards more promising transition economies and possibly to the EU, and
- b) for the sake of the country's survival economically and socially.

Otherwise, the country may be politically unsustainable.

An alternative solution was recently introduced, with first the SECI initiative and then the Stability Pact.

The Stability Pact introduces economic co-operation between transition countries and in particular the Balkan region countries as: the best, a necessary and most promising solution for the better future of the countries in question, and for the international community as a whole, with particular reference to Europe.

---

<sup>30</sup> Horvat, B. *ibid.* p.170

However, the Stability Pact as the best solution for the countries in point, needs still to be elaborated in more technical details in order to become productive as expected by its promoters. Action must be accelerated, because we time is running short.

We can conclude that the Stability Pact, if unchanged, does not promise for the B-H economy the economic growth necessary to bridge the gap in "real economic indicators" between itself and the EU.

Joining a Balkan economic union under the present conditions of the Stability Pact could be a waste of time for the B-H economy.

Professor Horvat's "New Road" and the model of Balkan economic integration as described in his book is more promising in terms of economic growth, and should be much more satisfactory from the point of view of both the B-H and the Croatian economy. But, the proposal is far from present political reality, both in B-H politics and in international political circles.

Therefore, the next best solution which is the independent road towards the EU, and which has so far been based on the Washington Consensus, paradoxically looks like the best solution for the B-H society.

However, this warning must be given: the income disparities between B-H and the EU countries could be increased substantially with resumption of the present type of economic policy.

The quicker B-H joins the EU, the lower future disparities in income between her and EU might be.

But, we must conclude finally that it is the politicians, and not the economists, that will have to decide on this matter.

## References

- Bhagwati, J. (1998) 'The Capital Myth: The Difference between Trade in Widget and Dollars.' *Foreign Affairs*.
- Bhagwati, J. (1998) 'Poverty and Reforms: Friends or Foes.' *Journal of International Affairs*.
- Brabant, J. (1993) *Privatization in Post-Communist Societies - A Comment*. Harvard University.
- Brabant, J. (1991) *Integrating Eastern Europe into the Global Economy: Convertibility through a Payments Union*. Kluwer.
- Causevic, F. (2001) *Employment and Privatization*. (unpublished paper)
- Frydman, R., Murphy, K. and Rapaczynski, A.C. (1998) *Capitalism With A Comrade's Face*. CEU Press.
- Frydman, G.R. and Rapaczynski, A.C. (1996) *Corporate Governance in Central Europe and Russia*. CEU Press.
- Horvat, B. (1995) *Privatization vs. Deetatisation*. (unpublished paper)
- Horvat, B. (1993) *The Program for Economic Development for Croatia*. Zagreb.
- Horvat, B. (1999) *The Theory of International Trade*. Macmillan.
- Horvat, B. (2001) *New Deal for Croatia*. (unpublished paper)
- Kapur, D. (1999) *The International Monetary Fund: A Cure or a Curse*. Cooperation South, UNDP.
- Krugman, P. (1994) 'Competitiveness: A Dangerous Obsession.' *Foreign Affairs*.
- Krugman, P. (1994) *Competitiveness: Does it Matter*. Chicago: Fortune.
- Krugman, P. and Stiglitz, J. (1992) *Towards a Counterrevolution in Development Theory*. World Bank.
- Krugman, P. (1995) 'Dutch Tulips and Emerging Markets.' *Foreign Affairs*.
- Mencinger, J. (1995) *Economic of Disintegration - Economic Price of the War*. Paris.
- Mencinger, J. (1996) *Privatization Dilemmas in BiH*. (unpublished paper). Ljubljana.

- Mencinger, J. (2000) *Enlargement and Convergence*. (unpublished paper presented at *Ten years of Transition*). Bologna University.
- Mertlik, L.K. and Bhaduri, A. (1996) *A Lessons to be Drawn From Mistakes in Transition Strategy*. The Vienna Institute for Comparative Studies.
- Murakami, J. (1996) *An Anticlassical Political-Economic Analysis*. Stanford Un. Press.
- Nolan, P. (1995) *China's Rise, Russia's Fall*. St. Martin Press.
- Panic, M. (1991) *Managing Reforms in the East-European Economies: Lessons From the Postwar Experience of West Europe*. Paper presented at Tenth Keynes Seminar. University of Kent.
- Panic, M. (1991) *The Future of the State in East-Europe*. University of Kent.
- Paque, K. and Schmieding, H. (1992) *The Fading Miracle*. Cambridge University Press.
- Pitelis, C. (2000) *Supply-Side Strategy for Productivity, Competitiveness and Convergence between the CEECs and (in) the EU*. PHARE-ACE Project in progress.
- Porter, M. (1990) *The Competitive Advantage of the Nation*. Macmillan.
- Porter, M. (1998) *The Adam Smith Address: Location, Clusters and the New Microeconomic Competition-Business Economics*. Washington.
- Stiglitz, J. (1998) 'Development Based on Participation - A Strategy for Transforming Societies.' *Transition*, Vol. 9., Number 6.
- Stiglitz, J. (2000) *What I have learned at the World Economic Crisis*. Internet.
- Stojanov, D. (1995) 'Some Unresolved Macroeconomic Issues of the Transition Process in Former Socialist Countries.' In *Economic Price of the Peace*. Paris.
- Stojanov, D. (1996) *Macroeconomic Policy Issues Relating to Transition to A Market Economy in Bosnia and Herzegovina*. Vienna: UNDP.
- Stojanov, D. (1997) *Strategy for Economic Development of BiH*. UNDP.
- Stojanov, D. (2001) *Croatian Economy on Cross-road: Between East and West*. Rijeka International Conference. Rijeka, Croatia.
- UNDP (1996) *Macroeconomic Policy Issues Relating to Transition to a Market Economy in Bosnia and Herzegovina*. Vienna: UNDP.
- UNDP B-H (2000) *Early Warning System*.
- United Nations Economic Commission for Europe (1995) *Economic Integration in Europe and North America*. New York, Geneva.
- Vidovic, H., Riegel, V. and Heuberger, V. (1999) *At the Crossroads: Disaster or Normalization? The Yugoslav Successor States in the 1990s*. Peter Lang.
- Wolf, H. (1999) *Transition Strategies: Choices and Outcomes*. IFS, Princeton University.
- World Bank (1996) *BiH on the Road to Recovery*.